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Techniques and Developments in Defending against Tender Offers: Warding Off the Voracious Conglomerate

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TECHNIQUES AND DEVELOPMENTS IN DEFENDING AGAINST TENDER OFFERS: WARDING OFF THE VORACIOUS CONGLOMERATE

> In recent years we have seen proud old companies reduced to corporate shells after white-collar pirates have seized control with funds from sources which are unknown in many cases, then sold or traded away the best assets, later to split up most of the loot among themselves.[1]
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> We need to strengthen our antimerger laws and not weaken them. We are at the crossroads and the future of American capitalism is at stake.[2]

The fear of corporate takeover through the use of tender offers has generated widespread and emotional reactions in the business and political communities. The objective of the acquisitive conglomerate to gain control of other corporations by means of a tender offer presents a direct threat to the personal and financial well-being of those members of management whose companies are selected as acquisition targets. Management frequently seeks to camouflage this threat to its own longevity by alleging negative economic consequences. Thus they will point to over-centralization, general concentration of ownership, the possibility of reciprocal buying, and the creation of barriers to entry.[3] These fears represent the more common outcries raised against conglomerate acquisitions.[4]

The impact of tender offers has been to elevate affected shareholders from the "limbo of impotent ownership"[5] to the status of a meaningful participant in corporate affairs. Target management is being forced to deal with factors and variables never imagined by their predecessors. The threat of takeover has been vividly described:

> The targets of this aggression are some of the most upright, prudent, powerful, and self-assured corporations in the land. Self-assurance is fading. Proud old names have already been taken over, and dozens of veteran executives have been sacked. Foreboding, frustration, and even fear are epidemic in perhaps three out of five big corporate headquarters. Anguished executives who should be minding the shop are instead behaving as if they were up to some underhanded adventure, spending long hours counseling with lawyers, management consultants, proxy specialists, and public-relations men skilled in the art of forefending take-overs.[6]

The purpose of this Comment is not to justify management's actions in

[1] 111 CONG. REC. 28257 (1965) (remarks of Senator Williams).
[2] 111 CONG. REC. 28853 (1965) (remarks of Congressman Patman).
[3] Bork, *Antitrust in Dubious Battle*, FORTUNE, Sept. 1969, at 160.
[4] *Id.*
[5] Burck, *The Merger Movement Rides High*, FORTUNE, Feb. 1969, at 79.
[6] *Id.* at 80.

protecting itself, but rather, to examine the array of legal weaponry employed by management in practicing the "art of forefending take-overs."

I. TENDER OFFERS: CONTROL AND REGULATION

While the majority of acquisitions result from mergers which have been planned in advance by all parties concerned, the more dynamic acquisitions (or attempts thereto), arise from the making of a tender offer.

The terms "target" and "offeree" corporation are used interchangeably in reference to the corporation for whose stock the tender offer is being made. Typically, a target corporation is one with high liquidity, low debt-equity ratio, and a stable position in its market area. However, these criteria are not exclusive.[7] Exclusiveness is precluded by the complexity of factual settings involved in tender offers.

A tender offer is a public offer to target corporation shareholders for the purchase of all or part of the target's stock at a fixed price above the prevailing market and within a specified period of time.[8] The acquirer, therefore, circumvents company management and appeals directly to the shareholders.

The consideration offered for the shares tendered generally consists of cash and/or securities depending upon the financial position and goals of the acquirer. The exchange type offer which employs securities as consideration, can have a remarkable effect on the apparent "growth" rate of the acquirer in terms of its price-earnings ratio. For example, assume that the acquirer has one million shares outstanding earning $1 per share and selling at $30 per share. Assume further that the target also has one million shares outstanding earning $1 per share, but because of poor market acceptance, the shares are selling at only $10. If through a tender offer, the acquirer exchanges 500,000 of its own shares for all one million of the target's shares, the target shareholders have, in effect, sold their stock at $15 per share. Hence, the acquiring corporation now has one and one-half million shares outstanding and is earning $2 million. Translated, the earnings per share of the acquiring corporation have risen from $1 per share to $1.33 per share simply through an exchange of paper and not through internal growth.[9] This "chain letter effect"[10] is a subject of concern to

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[7] *See, e.g.*, Vance, *Is Your Company a Take-Over Target?*, 47 HARV. BUS. REV. 93 (1969).

[8] For a detailed discussion of tender offers, see Cohen, *A Note on Takeover Bids and Corporate Purchases of Stock*, 22 BUS. LAW. 149 (1966); Fleischer & Mundheim, *Corporate Acquisition by Tender Offer*, 115 U. PA. L. REV. 317 (1967); Schmults & Kelly, *Cash Take-Over Bids—Defense Tactics*, 23 BUS. LAW. 115 (1967); Comment, *Defensive Tactics Employed by Incumbent Managements in Contesting Tender Offers*, 21 STAN. L. REV. 1104 (1969); Comment, *Senate Bill 510 and the Cash Tender Offer*, 14 WAYNE L. REV. 568 (1968).

[9] Burck, *supra* note 5, at 81. *Fortune's* example is fairly unfettered and presents the numbers method of acquisition in a form which is easy to understand.

government agencies as well as to the accounting community. In an effort to penetrate the maze of numbers surrounding the actual measure of an acquirer's growth, the Accounting Principles Board has established stringent requirements for the reporting of earnings per share.[11] By requiring disclosure of earnings to reflect potential dilution,[12] theoretically an investor will be more able to appraise the conglomerate in the marketplace.

In response to the increased use of tender offers, state legislatures have enacted statutes which serve to aid target managements.[13] This legislative aid to entrenched management usually takes the form of a requirement that the offeror disclose its intention to the target company prior to making a tender offer. This effectively eliminates the element of surprise thereby allowing target management time to marshal resources in defense. Ohio's recent statute[14] involving tender offers contains stringent notice provisions which require that the offeror make a public announcement of the takeover terms at least twenty days prior to the commencement of the offer.[15] Moreover, the statute prohibits a tender offer if the offeror has purchased at least five per cent of the target corporation's stock within one year unless the offeror made a public announcement of his intention to gain control prior to his purchase.[16] While the element of surprise has been discounted recently as the single most important factor in a successful tender offer,[17] it

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10 *Id.*

11 APB ACCOUNTING PRINCIPLES at 6609 (1969). For a detailed discussion of this topic see Comment, *An Analysis of Accounting and Tax Considerations Which Affect Conglomerate Growth*, 3 LOY. L.A. L. REV. 348 (1970).

12 "The value of a common stock is said to be diluted if there is an increase in the number of shares without a corresponding increase in assets and earning power. Dilution may arise through split-ups, stock dividends, offers of subscription rights at a low price, and issuance of stock for property or services at a low valuation per share." B GRAHAM, D. DODD & S. COTTLE, SECURITY ANALYSIS 615 (4th ed. 1962).

13 *See, e.g.*, Take-Over-Bid Disclosure Act, 3 VA. CODE ANN. §§ 13.1-528 to 541 (Cum. Supp. 1968) (Section 13.1-531(a) requires that the offeror file an informational statement with the Corporation Commission ten days prior to the commencement of the takeover bid; Section 13.1-535 grants the Commission power to issue an injunction for the violation of the Act, as well as power to punish violations of injunctions by contempt); Act No. 337, Gen. Sess. [1968] (5 Purdon's Pa. Leg. Ser. 932, 1968), *amending* 40 PA. STAT. ANN. § 459 (1954) (The Act requires the approval of the Pennsylvania Insurance Commissioner in connection with the acquisition of Pennsylvania insurance companies); OHIO REV. CODE ANN. § 1707.04.1 (Supp. 1969).

14 OHIO REV. CODE ANN. § 1707.04.1 (Supp. 1969).

15 *Id.* § 1707.04.1(B)(1). The statute does not define what is meant by "announces publicly". If the intent of the legislature is to protect target management, does it really matter if the shareholders are notified?

16 *Id.* § 1707.04.1(B)(2).

17 Herzel, *Stock-for-Stock Tender Offers*, in CREATIVE ACQUISITION TECHNIQUES 165 (H. Eglit ed. 1969).

In exchange type offers, the offeror may have to register the issue with the SEC and qualify it with the various Blue Sky Commissioners, all of which would certainly give prior notice to the target company. The element of surprise in that case never would seem that requiring notice would be the maximum legislative protection accorded entrenched management short of outlawing the tender offer device.

Prior to the enactment of the Williams Bill in 1968,[18] federal regulation of tender offers was confined principally to SEC Rule 10b-5.[19] This rule proscribes the fraudulent or misleading sale or purchase of any security involving interstate commerce or the mails.[20] The difficulty with Rule 10b-5 as applied to tender offers is the requirement that the plaintiff must be a buyer or seller of the security in question. "[T]he decided consensus thus far is that the target company itself does not have standing . . . under Rule 10b-5."[21] The Williams Bill, which amended Sections 13 and 14 of the Securities and Exchange Act of 1934 (1934 Act), does, however, grant the target company standing to sue under the new Section 14(e).[22] Professor Loss has stated:

> The potential of § 14(e) in this context is one of the many reasons why that provision will bear watching. For, together with the related provisions on tender offers that were enacted in 1968, it offers a fertile new field for the fascinating process we have been witnessing in recent years whereby the courts, largely under the aegis of Rule 10b-5 and the proxy rules, have been developing what is in a real sense a federal corporation law.[23]

The main thrust of the Williams Bill is to protect tendering shareholders and not to aid target management.[24] These safeguards are implemented by requiring that more information be given the shareholder in order to formulate his investment decision.[25] The statute also provides that the target shareholder shall benefit from any increase in the offering price during

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exists. On the other hand, in a cash tender offer a quickly executed takeover can result in a lower premium being paid for the shares tendered since there is less time for management's action to have an effect on raising the market price to the offering price.

18 15 U.S.C. §§ 78m-n (Supp. IV 1969), *amending* 15 U.S.C. §§ 78m-n (1964).

19 17 C.F.R. § 240.10b-5 (1969).

20 *Id.*

21 Loss, The Role of Rule 10b-5 in Tender Offers at 5 (1969) (Special report of SEC REG. AND TRANSFER REP.).

22 *Id.* at 7. *See also* discussion at Section IV. A. *infra.*

23 Loss, *supra* note 21, at 7.

24 The bill in its original form would clearly have been an aid to target management due to the twenty day warning provision. S. 2731, 89th Cong., 1st Sess. (1965) (text of S. 2731 is reproduced in *Senate Bill 510 and the Cash Tender Offer*, *supra* note 8, at 589).

25 17 C.F.R. § 240.14d-4 (1969) provides that Schedule 14D [17 C.F.R. § 240.14d-101 (1969)] must be filed with the SEC if the target management recommends that the shareholders either accept or reject the tender offer. Schedule 14D must contain, among other things, information on (1) the security and the issuer, (2) the identity and background, including any arrangements target management has with the offeror, (3) the identity of persons retained or employed by the target management to aid in their recommendations or solicitations.

the tender offer.[26] Furthermore, if more shares than were originally bid for by the offeror are delivered, the number of shares to be accepted from each stockholder will be determined on a pro-rata basis,[27] thereby eliminating the pressure on the shareholder to tender his shares early in the offering period. And should the shareholder change his mind after tendering, he has the right to withdraw his stock within certain time limitations.[28]

Further federal regulation of tender offers seems certain; the possibilities afforded to both the target company and the offeror under Section 14(e) are simply too convenient to be ignored by either side. Future federal legislation, if designed to protect target management, would probably follow the pattern set in Ohio by requiring prior notice. Such federal notice requirements would seemingly have the effect of eliminating contested cash tender offers. Until contested tender offers are effectively removed by restriction or regulation, target management is relegated to the use of presently available defense tactics which do not always operate in the best interest of the target corporation and its shareholders. Generally these tactics can be classified into three broad categories. First, are tactics which will be labelled as preventive in nature. Second, are those tactics which are primarily defensive. Third, are tactics which constitute direct attack on the offeror.

II. PREVENTIVE TACTICS

A. Establishing an early warning system

In preparing a tender offer, the prospective offeror generally will collect as much information concerning the target as possible. This information is gathered in many instances through the use of corporate espionage and bribery.[29] If these activities are uncovered, the target company can seize the initiative by taking preventive action prior to the announcement of the offer. The absence of the offer operates to give greater persuasive power to target management when they present their position.

A prospective offeror seeking to establish a position in a target corporation's stock prior to making an offer[30] may be forced to warn the target company if his position exceeds ten per cent of the target's outstanding stock. Rule 13d-1[31] requires the owner of more than ten per cent of any equity security registered pursuant to Section 12 of the 1934 Act to furnish the issuer a statement within ten days of purchase, disclosing the identity of the owner and other information.[32]

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26 15 U.S.C. § 78n(d)(7) (Supp. IV 1969).
27 *Id.* § 78n(d)(6).
28 *Id.* § 78n(d)(5).
29 *How to Fend Off a Take-Over*, FORTUNE, Feb. 1, 1969, at 83.
30 *Id.*
31 17 C.F.R. § 240.13d-1 (1969).
32 Schedule 13D [17 C.F.R. § 240.13d-101 (1969)] requires information concerning

The target's shareholder list may also operate as a warning device unless large blocks of stock are registered under nominee or street names. Similarly, the pattern of trading could be studied to provide an indication of a build up in position by prospective offerors.

Finally, management should consider the drafting of a confidential document outlining a course of action in the event of a tender offer.[33] The existence of this document would facilitate rapid coordinated action were a tender offer to be made. This ability to respond would be of great value when the success of the tender offer was dependent upon the element of surprise.

B. Amending the articles or certificate of incorporation

Amending the articles or certificate of incorporation to provide for the abolition of cumulative voting, reclassification of directors and the formation of a staggered board of directors in order to render a takeover of control more difficult has been suggested.[34] However, these devices may not be available under the laws of the target's state of incorporation and attempts to circumvent such restrictions may not be successful. For example, California, by statute, grants every shareholder the right to cumulative voting[35] while Delaware does not unless it is specifically set forth in the articles of incorporation.[36] Reincorporation of a California corporation in Delaware for the purpose of avoiding the effects of cumulative voting may be prohibited in certain circumstances. In *Western Air Lines, Inc. v. Sobieski*,[37] a California court held that a Delaware corporation, which had exchanged shares with its California predecessor, would not be allowed to deprive California shareholders of their right to cumulative voting. The court resolved the conflicts of law question on the basis that California had a greater interest in the voting rights of the shareholders.[38]

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(1) the security and the issuer, (2) identity and background of the offeror, (3) source and amount of funds or other consideration to be used in the offer, (4) purpose of the offer, offeror's plans with respect to the target corporation, (5) interest in the securities of the target corporation, (6) contracts, arrangements, or understandings with respect to the securities of the target corporation, and (7) persons retained or employed to aid in the offer.

33 O'Hanlon, *Goodrich's Four-Ply Defense*, FORTUNE, July 1969, at 110; *see also* Comment, *Defensive Tactics Employed by Incumbent Managements in Contesting Tender Offers*, 21 STAN. L. REV. 1104, 1106-07 (1969).

34 Address by William L. Cary, *Defensive Tactics with Respect to Tender Offers*, ABA Symposium on Conglomerates, New York, Oct. 1969.

35 CAL. CORP. CODE § 2235 (West 1955).

36 8 DEL. CODE ANN. § 214 (Cum. Supp. 1968).

37 191 Cal. App. 2d 399, 12 Cal. Rptr. 719 (1961).

38 An injunction against the holding of shareholder meetings was granted the Commissioner in People *ex rel.* Sobieski v. Western Airlines, Inc., 258 Cal. App. 2d 213, 66 Cal. Rptr. 316 (1968).

Generally, cumulative voting is not required of foreign corporations as a matter of fairness by the California Commissioner in regard to the offer and sale of securities.

Similarly, an amendment to the articles or certificate of incorporation for the purpose of providing a greater than conventional majority vote in order to effect a merger or consolidation may be helpful in that it places an additional burden on the offeror. Such an amendment may have an adverse effect by hindering or preventing a merger with a friendly corporation if target management should decide to use the merger as a defense to a tender offer.

C. *Change in debt structure*

As a company increases its leverage,[39] it may reduce its potential as an acquisition target[40] primarily because cash-poor offerors tend to prefer to financing tender offers with the resources of the acquired company. However, there is obviously no guarantee that high leverage will prevent a prospective acquisition, and a debt undertaking simply for the purpose of making the corporation less vulnerable to attack would certainly be questionable in terms of the directors' duties to the corporation. Clearly, any borrowing motivated by a desire to stay in office would be a breach of the directors' duties of loyalty. Such a breach would expose the directors to liability from suit brought by the corporation and shareholders, including the offeror.[41] The potential harm to the directors and corporation militate against this method.

An example of the leverage method is seen in the reactions of B.F. Goodrich to a tender offer by Northwest Industries. Goodrich increased its line of credit with twenty-one banks to $250,000,000.[42] The credit agreements specified that the loans would be in default if Goodrich was ac-

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However, the Commissioner is empowered to require "cumulative voting as an element of fairness in light of all of the facts and circumstances in an extraordinary case." H. MARSH & R. VOLK, PRACTICE UNDER THE CALIFORNIA CORPORATE SECURITIES LAW OF 1968, 254 (1969).

39 Leverage is described in C. MOORE & R. JAEDICKE, MANAGERIAL ACCOUNTING 75 (1963):

> Management will sometimes try to increase the rate of return on the owners' equity by using resources furnished by outsiders. If borrowed assets can be put to work to earn a return in excess of the interest cost, the owners will benefit. Suppose that $100,000 can be borrowed at 5% and put to work to earn 10%. The owners receive a $5,000 return without any investment on their part. Using borrowed assets to enhance the return to the owners is spoken of as *leverage* or as *trading on the equity*.

See also SECURITY ANALYSIS, *supra* note 12, at 636-48.

40 *How to Fend Off a Take-Over*, *supra* note 29.

41 The directors' primary duty is to the corporation. The court in Bancroft-Whitney Co. v. Glen, 64 Cal. 2d 327, 411 P.2d 921, 49 Cal. Rptr. 825 (1966), stated that,

> While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing throughout the years, derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation . . . . *Id.* at 345, 411 P.2d at 934-35, 49 Cal. Rptr. at 838-39.

42 O'Hanlon, *supra* note 33, at 189.

quired.[43] Goodrich also planned to lock-in the funds borrowed by prepaying income taxes and accounts payable:[44]

> The details of this extreme maneuver were revealed by the Goodrich lawyers during the final minutes of the Justice Department's antitrust case in Chicago last month. Judge Herbert L. Will was astonished. Likening the amendment to a 'Herman Goering cyanide pill,' Judge Will wondered why Goodrich would voluntarily enter into an agreement 'under which it threatened to commit financial suicide in the event that this transaction is consummated. It's a shocking document. It's the worst indictment of Goodrich management of anything in the record in this case.'[45]

The Goodrich situation is an illustration of entrenched management with a poor performance record attempting to ward off a conglomerate acquisition.[46]

The Goodrich debt undertaking raises serious questions regarding a director's duties of loyalty and care. The timing of the transaction would seem to be sufficient to raise the issue of an improper self-perpetuation motive. In addition to the shareholder action for breach of fiduciary duty there is a possibility that a suit could be brought against the target corporation and the banks for conspiring to violate Rule 10b-5.[47] This last possibility was not discussed in the *Goodrich* case.

III. Defensive Tactics

A. Stock-splits

A stock-split is a recognized defense tactic.[48] The effect of this tactic is more psychological than pecuniary in that the equity value of the shareholder's interest remains unchanged. In announcing a stock-split, the corporation may require shareholders to tender their shares to a transfer agent for replacement instead of issuing additional certificates. In this way the certificates would be unavailable for tender to the offeror. This tactic is generally considered to be good corporate practice because it is desirable to have all certificates outstanding reflect the decrease in par value brought about by a stock-split.[49]

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[43] *Id.*

[44] *Id.*

[45] *Id.*

[46] At the time of the Northwest Industries tender offer, Goodrich's profits were $2 million less than what they were in 1955. Its 1968 return on invested capital was only 8.1% as compared with Firestone's 12.6% and Goodyear's 12.8%. *Id.* at 112.

[47] The question of the sufficiency of alleging a breach of corporate fiduciary duties in order to sustain an action under Rule 10b-5 was considered in O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964). The court stated that merely alleging a breach of fiduciary duty was not sufficient and that "[N]o cause of action is stated under Rule 10b-5 unless there is an allegation of facts amounting to deception." *Id.* at 768.

[48] *See generally* Schmults & Kelly, *supra* note 8, at 118; *Defensive Tactics Employed by Incumbent Managements in Contesting Tender Offers*, *supra* note 8, at 1120.

[49] Is there any basis for this practice when no-par shares are involved?

Perhaps the most beneficial effect of a stock-split is the delay it causes thereby giving the market-price an opportunity to rise to the tender price resulting in a diminished chance of acquisition.[50]

B. *Increasing the dividend*

Increasing the dividend is another defensive tactic which has the effect of providing a shareholder with some measure of satisfaction as to his present investment.[51] But this measure of satisfaction will normally be outweighed by the larger gain to be realized upon acceptance of the tender offer. Moreover, if the increased dividend is entirely artificial the target corporation runs the risk of suit by the offeror and the shareholders for misrepresentation under Rule 10b-5 and Section 14(e). It seems clear that the diversion of corporate funds, in addition to the possibility of suit, may well outweigh the usefulness of this tactic.

C. *Increasing the number of shares outstanding*

An increase in the number of outstanding shares by the issuance of additional stock may also be effective in hindering tender offers although the offeror may simply increase its tender offer. On the other hand, the mechanics of the issuance may take too much time, particularly if the offeror decides to contest the registration or qualification of the securities. In addition, the purpose of the issuance may not be in the best interests of the target corporation and thus render it questionable in terms of the directors' duty of loyalty with the potential result being a cancellation of the issue.[52] The issue of new shares may also result in a violation of Rule 10b-6[53] if the target corporation later purchases the new shares in an effort to retain controlling interest.

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50 Consider the arbitrage opportunities in this context; *see* Robertson, *Personal Investing—A Feast for the Arbitrageurs*, FORTUNE, Feb. 1969 at 165.

51 *See* Schmults & Kelly, *supra* note 8, at 117-18; *Defensive Tactics Employed by Incumbent Managements in Contesting Tender Offers*, supra note 8, at 1120.

52 In Condec Corp. v. Lunkenheimer Co., 43 Del. Ch. 353, 230 A.2d 769 (Ch. 1967), plaintiff Condec had acquired a majority of Lunkenheimer stock by tender offer. Lunkenheimer's directors then sought to issue additional stock which it planned to exchange for the stock of its ally, U.S. Industries. The Delaware court cancelled the new issue stating that it:

> was clearly unwarranted because it unjustifiably strikes at the very heart of corporate representation by causing a stockholder with an equitable right to a majority of corporate stock to have his right to a proportionate voice and influence in corporate affairs to be diminished by the simple act of an exchange of stock which brought no money into the Lunkenheimer treasury, was not connected with a stock option plan or other proper corporate purpose, and which was obviously designed for the primary purpose of reducing Condec's stock holdings in Lunkenheimer below a majority. *Id.* at 365, 230 A.2d at 777.

53 17 C.F.R. § 240.10b-6(a) (1969).

D. Decreasing the supply of outstanding shares

By purchasing its own stock, a target corporation can accelerate the market price toward the level of the tender offer and thereby hinder the efficacy of the tender offer. Once again, Rule 10b-6 could hinder the target corporation in any attempt to purchase its own stock.[54] Under Rule 10b-6, issuers, dealers and underwriters who are involved in a distribution are prohibited, subject to certain necessary exceptions, from acquiring an interest in the security being distributed.

Also applicable is Section 13(e) of the 1934 Act, which grants to the SEC broad power to regulate the purchase, by an issuer, of its own shares.[55] So far, only Rule 13e-1 has been promulgated and it requires disclosure whenever the target corporation purchases its own stock after a tender offer has been made for the target's stock.[56] It has been suggested[57] that future rules under Section 13(e) may follow the guidelines stated in the *SEC v. Georgia-Pacific Corp.* consent decree.[58] Georgia-Pacific had previously entered into agreements to acquire other corporations. Evaluation periods were established pursuant to these agreements in order to determine the proper exchange ratios. The SEC charged that defendants had purchased Georgia-Pacific stock during and prior to the evaluation period thereby causing the stock price to rise so that fewer shares would be needed for the acquisitions. The consent decree enjoined the violation of the 1934 Act and called for the defendants to:

1. forego bidding for or purchasing any Georgia-Pacific security which is the subject of a distribution, or
2. when an agreement in principal has been reached to exchange Georgia-Pacific securities for the securities or assets of another, or
3. during and prior to evaluation periods of Georgia-Pacific securities, or
4. at other times under certain restrictive conditions, and
5. to furnish information in regard to purchases of Georgia-Pacific to

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54 17 C.F.R. § 240.10b-6(a) (1969) provides that it is a "'manipulative or deceptive device or contrivance' as used in section 10(b) of the [1934 Act]" for an underwriter, broker, dealer or issuer who has agreed to participate, or who is participating, in a distribution of the issuer's securities, "to bid for or purchase for any account in which he has a beneficial interest, any security which is the subject of such distribution . . . ." Moreover, § 240.10b-6(b) provides that "The distribution of a security . . . which is immediately exchangeable for or convertible into another security, or . . . which entitles the holder thereof immediately to acquire another security, shall be deemed to include a distribution of such other security within the meaning of this section."

55 15 U.S.C. § 78m(e)(1) (Supp. IV 1969), *amending* 15 U.S.C. § 78m (1964).

56 17 C.F.R. § 240.13e-1 (1969).

57 Address by W. McNeil Kennedy, *Defensive Take-Over Procedures Since the Williams Bill*, Symposium on Securities Regulation Corporate and Tax Aspects of Securities Transactions, Dallas, Texas, April 24, 1969.

58 [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,692; 95,524 (S.D.N.Y. 1966).

parties with whom Georgia-Pacific is conducting serious acquisition negotiations.[59]

If the foregoing are embodied in future regulations, any price raising device by the target corporation through the purchase of its own shares may be precluded or at least hindered. As it now stands, the effect of Rule 13e-1 and its disclosure requirement is to increase the possibility of exposure to a violation of Rule 10b-6 should the target corporation engage in a distribution and purchase of its own stock.

There is a possible beneficial side effect to the target corporation when it reduces the number of shares outstanding. Assume the offeror's position in the target stock has risen above ten per cent of the total outstanding shares based on a decrease in the number of outstanding shares. A subsequent sale by the offeror within six months from date of purchase will fall within the purview of Section 16b of the 1934 Act[60] and all profits from the sale would go to the target corporation. On the other hand, if the sale takes place after six months from date of purchase or the ten per cent level was not reached, the offeror might still be able to profit on the sale of shares bought prior to the offer assuming there has been a rise in the market price of the stock approaching the tender offer.

E. Creation of antitrust problems and the placing of stock in friendly hands

The acquisition of other corporations by the target corporation may benefit its defensive position in two ways. First, the acquisition may be designed to create antitrust problems for the prospective acquirer. For example, B.F. Goodrich was advised to, and did, buy a trucking company for the purpose of creating a restraint of trade problem for the transportation oriented Northwest Industries ("Northwest") in the event that the tender offer was successful. However, the ICC declined to intervene in the matter and Northwest indicated that it would sell the trucking company in the event that the tender offer was successful.[61] The efficacy of this tactic is limited and should be employed only when the target corporation can definitely expect intervention of a federal agency.

Secondly, acquisitions in exchange for shares of the target corporation have the effect of placing the stock in friendly hands, thereby making it more difficult for the offeror to gain control. This tactic was considered in the Goodrich case wherein twenty per cent of Goodrich's stock was to be placed in friendly hands.[62]

Goodrich's ally was Gulf Oil Corporation ("Gulf"). For several years prior to Northwest's tender offer, Goodrich and Gulf had operated Good-

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[59] *Id.* at 95,525-26.
[60] 15 U.S.C. § 78p(b) (1964).
[61] O'Hanlon, *supra* note 33, at 110.
[62] *Id.*

rich-Gulf Chemicals, Inc. ("Chemicals") as a joint venture, each party having an equal interest. Although both Goodrich and Gulf had negotiated in the past for the purchase by one party of the other's interest in Chemicals, the Northwest tender offer provided the catalyst. "After a single day of negotiations, Goodrich agreed to exchange $35 million of its common stock [700,000 shares] for Gulf's share. The next day the purchase was approved by Goodrich's board of directors."[63]

Northwest Industries, as a minority shareholder of Goodrich, brought suit to enjoin the purchase. The District Court denied the request for a preliminary injunction stating that Northwest failed to prove that the primary motivation was "Goodrich officials' desire to remain in office. . . ."[64] Also, Northwest had failed to show that there was any fraud involved since it appeared by the facts that "$35 million [was] a fair price for Gulf's one half of Chemicals."[65] Northwest was precluded from proving Goodrich's primary motivation of survival once it was shown to the court's satisfaction that the price Goodrich paid was fair. Goodrich's success indicates that management's desire to stay in office can be shielded from question by selecting a business opportunity which, standing alone, does not constitute waste or fraud.

F. Defensive mergers

Another tactic is to arrange a defensive merger with a friend, and thereby remove the target from the acquisition market. The offeror may respond to this tactic by raising the tender price or by simply proposing an attractive merger of its own. Despite this response, target management has the distinct advantage of being able to offer its shareholders a "tax free" exchange,[66] while acceptance of the tender offer may mean immediate tax consequences. It is possible that this advantage may be gained by the offeror in proposing a merger of its own; however, such a drastic change of attack generally means forfeiting the relatively quick process of the tender offer to the more cumbersome and time consuming proxy system.

The defensive merger is considered by some to be the only effective way to defeat a tender offer.[67] The problem is that a poorly planned merger may be just as disastrous to management as succumbing to a tender offer.

[63] Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 708 (N.D. Ill. 1969).

[64] *Id.* at 712.

[65] *Id.*

[66] INT. REV. CODE of 1954, § 368.

[67] Herzel, *supra* note 17, at 175, states:

> The one technique of resistance which has been very successful is a competing merger [defensive merger]. Most other techniques for resistance that are mentioned in the literature on the subject have very little chance for success and are often unrealistic or dangerous. It has sometimes been suggested that the resisting company increase dividends, split its stock or purchase its own stock. In some situations these techniques will be clearly unlawful, in others impractical; rarely are they any substantial help in resisting the tender offer.

One solution is that target management should plan as far in advance as possible to ensure the most efficient and compatible combination.

G. *Management communications*

Generally, once a tender offer has been made public, the initial response by target management is to communicate with its shareholders.[68] Although management is not required to make a recommendation to the shareholders to either accept or reject the tender offer, it has been noted that the SEC "seems to be leaning in favor of requiring such a recommendation."[69] If management does offer a recommendation to its shareholders, it will have to file a Schedule 14D with the SEC.[70] The disclosure required by Schedule 14D is minimal at present but is expected to develop parallel to the proxy rules.[71]

Additionally, the disclosure required by Schedule 13D,[72] when filed by the offeror, may provide grounds upon which target management may argue against the tender offer in its communications to the target shareholders. For example, required disclosure of the offeror financing,[73] may give the target an opportunity to argue that the offeror intends to effectuate the takeover by the use of the tendered shares or target funds as collateral. The persuasive power of such a communication is doubtful if the shareholders are concerned solely with realizing a gain from the sale.

On the other hand, target management may successfully influence the source of the offeror's financing so as to cause a withdrawal of funds, thereby causing the withdrawal of the offer.

IV. DIRECT ATTACK

A. *Violation of Rule 10b-5 and Section 14(e)*

In the past the target corporation has had difficulty in using a violation of Rule 10b-5 as a basis for direct attack[74] mainly because of problems inherent in standing to sue under the Rule. Since the passage of the Williams Bill target management has standing to sue under Section 14(e) of the 1934 Act. The effect of Section 14(e) in this respect has been clearly sanctioned by the Second Circuit in *Electronic Specialty Co. v. International Controls Corp.*[75]

68 Address by Edward C. Schmults, *Contested Takeover Bids and Exchange Offers—Defensive Tactics*, Practicing Law Institute, in New York City, July 25, 1967.

69 Kennedy, *supra* note 57.

70 17 C.F.R. § 240.14d-4 (1969).

71 Kennedy, *supra* note 57.

72 17 C.F.R. § 240.13d-101 (1969).

73 *Id.*

74 Loss, *supra* note 21.

75 409 F.2d 937 (2d Cir. 1969).

The defendant, International Controls Corporation ("ICC") initiated merger negotiations with the plaintiff, Electronic Specialty Company ("ELS") in 1968, shortly after the enactment of the Williams Bill. Prior to those talks, ICC purchased 43,500 shares of ELS stock through Butlers Bank of Nassau. ELS had 1,800,000 shares outstanding and was listed on the New York Stock Exchange. ICC's attempted merger failed and on August 5, 1968, ELS announced its intention to merge with Carpenter Steel Co. Thereupon ICC entered into an oral agreement whereby ELS would purchase a maximum of 50,000 shares of ELS stock held by ICC at $42 per share. Relying on the advice of counsel that ICC would not be able to compel performance of the oral agreement, ICC's president placed a day order to sell up to 10,000 shares at a $35 limit; 5,400 shares were sold pursuant to the order.

The ELS-Carpenter merger announcement met with an unfavorable market reaction. Within ten days, ELS stock dropped from 38½ to 33⅛. At this point ICC's president recommended a tender offer. The tender offer was approved and on August 19, 1968, ICC published an offer to buy up to 500,000 shares of ELS at $39 per share. The offer was later increased to cover all ELS shares outstanding; a total of 1,200,000 of 1,800,000 shares were eventually tendered to ICC.

ELS reacted by filing a suit to enjoin ICC from proceeding with the tender offer. The Federal District Court denied ELS's motion for a preliminary injunction and bound the matter over for trial.[76] The trial court denied ELS's request that ICC be enjoined from voting its ELS stock and that ICC divest itself of its holdings in ELS.[77] The court then enjoined ICC from "further violations of the Act"[78] consisting of various public statements affecting the value of ELS stock.

On appeal, the Second Circuit held that the target corporation, along with both tendering and nontendering shareholders, had standing to sue for an injunction under Section 14(e).[79]

As to the substantive issue of Section 14(e) violations the court first dealt with the statement required of ICC by Rule 14d-1(c) regarding plans to merge the target corporation. ICC had stated that "the Company will give consideration to a merger between itself or a subsidiary and Specialty."[80] The court, in finding no violation, stated that "it would be as serious an infringement of these regulations to overstate the definiteness of the plans

76 Electronic Specialty Co. v. International Controls Corp., 296 F. Supp. 462 (S.D. N.Y. 1968).

77 Electronic Specialty Co. v. International Controls Corp., 295 F. Supp. 1063 (S.D. N.Y. 1968).

78 *Id.* at 1083.

79 409 F.2d at 944-46.

80 296 F. Supp. at 468.

as to understate them."[81]

The next violation alleged, concerned a report in the Wall Street Journal which contained certain inaccuracies as to the intended offering price and extent of ICC's holdings in ELS. Even though ICC was not responsible for the statements, ELS charged that ICC was under a duty to correct them. The court held that "[w]hile a company may choose to correct a misstatement in the press not attributable to it, . . . we find nothing in the securities legislation requiring it to do so."[82]

Following the ELS-Carpenter merger announcement, ICC's president released a statement over the Dow Jones broad tape saying, in effect, that ICC was no longer interested in ELS. On August 6, 1968, prior to the tender offer, ICC sold 5,400 shares of ELS. The court found that ICC's president was following the instructions of ICC's Board which had directed him to divest ICC of ELS stock if an agreement could not be reached. Thus the released statement was true at the time it was made and was not in violation of Section 14(e). Similarly, the sale of 5,400 shares was not an attempt to depress the market since ICC's president was following the Board's instructions.

The last violation alleged, concerned statements by ICC's president which were reported in the Wall Street Journal and were to the effect that ICC held approximately five per cent of ELS stock. This was an overstatement of ICC's holdings. The Journal also reported that ICC's "preference" was to sell their ELS stock. ICC's president denied making the statements and the reporter was not called to testify. The court found there was no violation and stated that "the episode reflects the difficulties commonly experienced in answering skilled and energetic reporters who seek more definiteness than there is. . . ."[83]

In discussing the test of materiality for misstatements under Section 14(e) the *Electronic Specialty* court affirmed the test set forth in *Symington Wayne v. Dresser Industries, Inc.*[84] The *Symington* rule required a determination whether "any of the stockholders who tendered their shares would probably not have tendered their shares if the alleged violations had not occurred."[85] The *Electronic Specialty* court noted:

> Congress intended to assure basic honesty and fair dealing, not to impose an unrealistic requirement of laboratory conditions that might make a new statute a potent tool for incumbent managements to protect its own interests against the desires and welfare of the stockholders. These considerations bear on the kind of judgment to be applied in testing conduct—of both sides—and also on the issue of materiality.[86]

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81 409 F.2d at 948.
82 *Id.* at 949.
83 *Id.* at 951.
84 383 F.2d 840 (2d Cir. 1967).
85 409 F.2d at 948.
86 *Id.* at 948.

The decision in *Electronic Specialty* is important in two respects. First, the court eliminates any question as to the standing of the target corporation and nontendering shareholders under Section 14(e). Thus the target corporation, in many cases, is no longer confronted with the standing problems under Rule 10b-5. Second, the court reaffirmed the *Symington* test of materiality in regard to allegations of substantive violations of Section 14(e). The standards established by the court in dealing with the specific allegations in *Electronic Specialty* should serve to aid in deterring frivolous suits by entrenched management under attack from a tender offer. Furthermore, the court chided the district court judges for their reluctance in granting preliminary injunctions. In view of the nature of tender offers, according to the court, and the variety of remedies available, the district court judges have the best opportunity to grant effective relief.

There are bases for suit which pose legitimate questions in light of the foregoing decisions. One untried basis for an allegation of violation of Section 14(e) would be an assertion that:

> [T]he offeror company is engaged in a fraudulent scheme by offering to pay brokers who solicit shares a double commission, which turns into a triple commission in the event the proceeds from the tender are reinvested. Does this deprive the offeree company shareholders of the unbiased advice of their own stockbrokers?[87]

Certainly the payment of double or triple commissions operates to promote a degree of self-interest on the part of stockbrokers. Disclosure alone will not defeat this self-interest but regulations eliminating such "bonus" commissions might be effective. Whether such commissions are denied or not, the fact remains that they have a manipulative effect by exerting false pressure on the market and should be disclosed under Section 14(e).

B. Other offensive tactics

In the Goodrich case management considered an attempt to have Northwest delisted from the New York Stock Exchange.[88] The various stock exchange rules may provide a basis for attacking the offeror but it seems that such an attack may be more vindictive than effective.[89]

Many target corporations have sought the aid of the state securities commissioners or their equivalent in preventing a takeover.[90] Similarly, if the proper justification exists, the intervention of a federal administrative agency such as the ICC or the FTC may effectively terminate the tender offer before it is successful.

Target management might also consider the possibility of making a ten-

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87 Kennedy, *supra* note 57.
88 O'Hanlon, *supra* note 33, at 110.
89 *See, e.g.*, N.Y.S.E., COMPANY MANUAL §§ A-16, A-179 (1963).
90 Kennedy, *supra* note 57.

der offer of its own to the shareholders of the offeror.[91] There would certainly be a host of problems, such as reaction time and financing, which would be inherent in such a counter-attack. On the other hand, the ensuing confusion from this maneuver might be sufficient in itself to quash the takeover attempt or achieve a similar effect by requiring the intervention of the SEC in order to protect the shareholders of both corporations.[92]

CONCLUSION

When faced with the possible loss of employment due to a takeover, it is doubtful that the response of entrenched management would be motivated primarily by the best interests of the corporation and the stockholders. Though the shareholder could ultimately benefit by a rise in the stock price due to a tender offer or management's responsive tactics, the inherent conflict of entrenched management creates an obvious risk of harm to the shareholders.

An example of the strength of this managerial instinct to survive at the expense of the shareholders was displayed when Hale Brothers Associates made a tender offer to the shareholders of Magnetics, Inc. The president and top officers of Magnetics threatened to resign and form a new company in competition with their former company. Consequently, the takeover failed. The president of Magnetics, commenting on the possibility of a shareholder suit, believed "that the Civil War was fought to guarantee Americans against involuntary servitude."[93] Implicit in this belief is the theme of self-survival and a disregard of the best interests of the target corporation and its shareholders.

Perhaps the reference to the Civil War is prophetic when one considers that all of the tactics discussed in this Comment cause dissension and polarization within the target corporation and among its shareholders. Indeed, no victor emerges after a contested tender offer in which lawsuits prevail and entrenched management disregard their primary duty; the protection of the corporation and shareholders.

The eventual solution is complete disclosure of all material facts in an effort to promote the most objective and rational decision by the target shareholders. This duty of disclosure must be equally borne by the offeror and target management with survival or predatory interests subordinated.

James Arthur Stubenberg

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91 Schmultz & Kelly, *supra* note 8, at 130.

92 *Id.*

93 *How to Fend Off a Take-Over, supra* note 29, at 162.